

**Department of the Treasury**  
**Tennessee Consolidated Retirement System**

**For the Year Ended**  
**June 30, 2001**

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**STATE OF TENNESSEE**  
**COMPTROLLER OF THE TREASURY**  
State Capitol  
Nashville, Tennessee 37243-0260  
(615) 741-2501

John G. Morgan  
Comptroller

March 12, 2002

Members of the General Assembly  
and  
The Honorable Steve Adams, Treasurer  
and  
Members of the Board  
Tennessee Consolidated Retirement System  
State Capitol  
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Tennessee Consolidated Retirement System for the year ended June 30, 2001. You will note from the independent auditor's report that an unqualified opinion was given on the fairness of the presentation of the financial statements.

Consideration of internal control over financial reporting and tests of compliance disclosed certain deficiencies, which are detailed in the Results of the Audit section of this report. The Tennessee Consolidated Retirement System's management has responded to the audit findings; the responses are included following each finding. The Division of State Audit will follow up the audit to examine the application of the procedures instituted because of the audit findings.

Sincerely,

John G. Morgan  
Comptroller of the Treasury

JGM/th  
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State of Tennessee

# Audit Highlights

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit  
**Tennessee Consolidated Retirement System**  
For the Year Ended June 30, 2001

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## AUDIT OBJECTIVES

The objectives of the audit were to consider the system's internal control over financial reporting; to determine compliance with certain provisions of laws, regulations, and contracts; to determine the fairness of the presentation of the financial statements; and to recommend appropriate actions to correct any deficiencies.

## INTERNAL CONTROL FINDINGS

### **The Tennessee Consolidated Retirement System (TCRS) Should Develop and Implement Written Procedures Related to the Preparation and Use of Credit Analysis Reports That Support the Purchase of Commercial Paper**

The investment policies of TCRS require the investment staff to prepare a credit analysis report on a corporation before TCRS purchases that corporation's commercial paper. However, guidance on certain aspects of preparing and using the reports is lacking. One directive needed is how often credit analysis reports should be updated. Other guidance needed is how the decision to purchase commercial paper contrary to the recommendation in the credit analysis report should be documented (page 8).

### **TCRS Should Strengthen Controls for Preventing, Detecting, and Collecting Overpayments to Deceased Persons**

TCRS staff did not comply with written procedures for death match reports. In addition, written procedures for death match reports were not sufficient to reduce risks associated with the death match process. TCRS staff did not comply with written procedures for overpayments. In addition, the written procedures did not always provide sufficient guidance for staff performing the procedures (page 9).

## **OPINION ON THE FINANCIAL STATEMENTS**

The opinion on the financial statements is unqualified.

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"Audit Highlights" is a summary of the audit report. To obtain the complete audit report, which contains all findings, recommendations, and management comments, please contact

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[www.comptroller.state.tn.us](http://www.comptroller.state.tn.us).

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**Audit Report**  
**Department of the Treasury**  
**Tennessee Consolidated Retirement System**  
**For the Year Ended June 30, 2001**

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**Department of the Treasury  
Tennessee Consolidated Retirement System  
For the Year Ended June 30, 2001**

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**INTRODUCTION**

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**POST-AUDIT AUTHORITY**

This is a report on the financial and compliance audit of the Tennessee Consolidated Retirement System. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which authorizes the Department of Audit to “perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller.”

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

**BACKGROUND**

The Tennessee Consolidated Retirement System (TCRS) was established in 1972 by an act of the Tennessee General Assembly. Seven existing retirement systems were consolidated to provide retirement, disability, and death benefits to state employees, public school teachers, higher education employees, and employees of participating local governments. State laws govern the retirement plan, and amendments to the plan can only be made by legislation enacted by the General Assembly of the State of Tennessee.

An 18-member Board of Trustees has the responsibility to manage and oversee the operation of the consolidated system. The board consists of nine *ex officio* members from the executive, legislative, and judicial branches of state government, eight representatives of the active TCRS membership, and one representative of retirees. TCRS is administered by the Department of the Treasury under the legislative branch of state government. By state law, the State Treasurer serves as Chairman of the Board of Trustees and as custodian of the funds of the system.

Membership in the retirement system is a condition of employment for full-time state employees, K-12 teachers, higher education general employees, and employees of participating local governments. Membership is optional for part-time state employees and part-time employees of political subdivisions which have authorized such coverage. Interim teachers and part-time teachers have optional membership. Faculty and certain other employees of institutions



of higher education may elect participation in either TCRS or an optional retirement program. TCRS membership has grown steadily since 1972, when there were approximately 93,000 members. As of June 30, 2001, there were 194,725 active members and 77,742 retirees.

## **ORGANIZATION**

The Tennessee Consolidated Retirement System is organized into three major service areas: Counseling Services, Member Services, and Financial Services.

Counseling Services is responsible for preretirement counseling of members on their potential benefit payments under different options. The section also processes claims for disability retirement and provides field support, including new employer coverage.

Member Services processes membership forms received from all state agencies, local boards of education, and participating political subdivisions. Prior-service specialists assist in establishing prior-service credit for eligible members or former members who have requested such credit. Benefit calculation specialists compute new retiree benefits based on the option chosen. The section is also responsible for researching, controlling, and correcting member records on the Treasury Retirement Accounting and Control System.

Financial Services processes refunds to terminated members, administers the retired payroll, distributes the pension payments, administers retiree insurance, and coordinates actuarial valuations.

An organization chart for the Tennessee Consolidated Retirement System is on the following page.

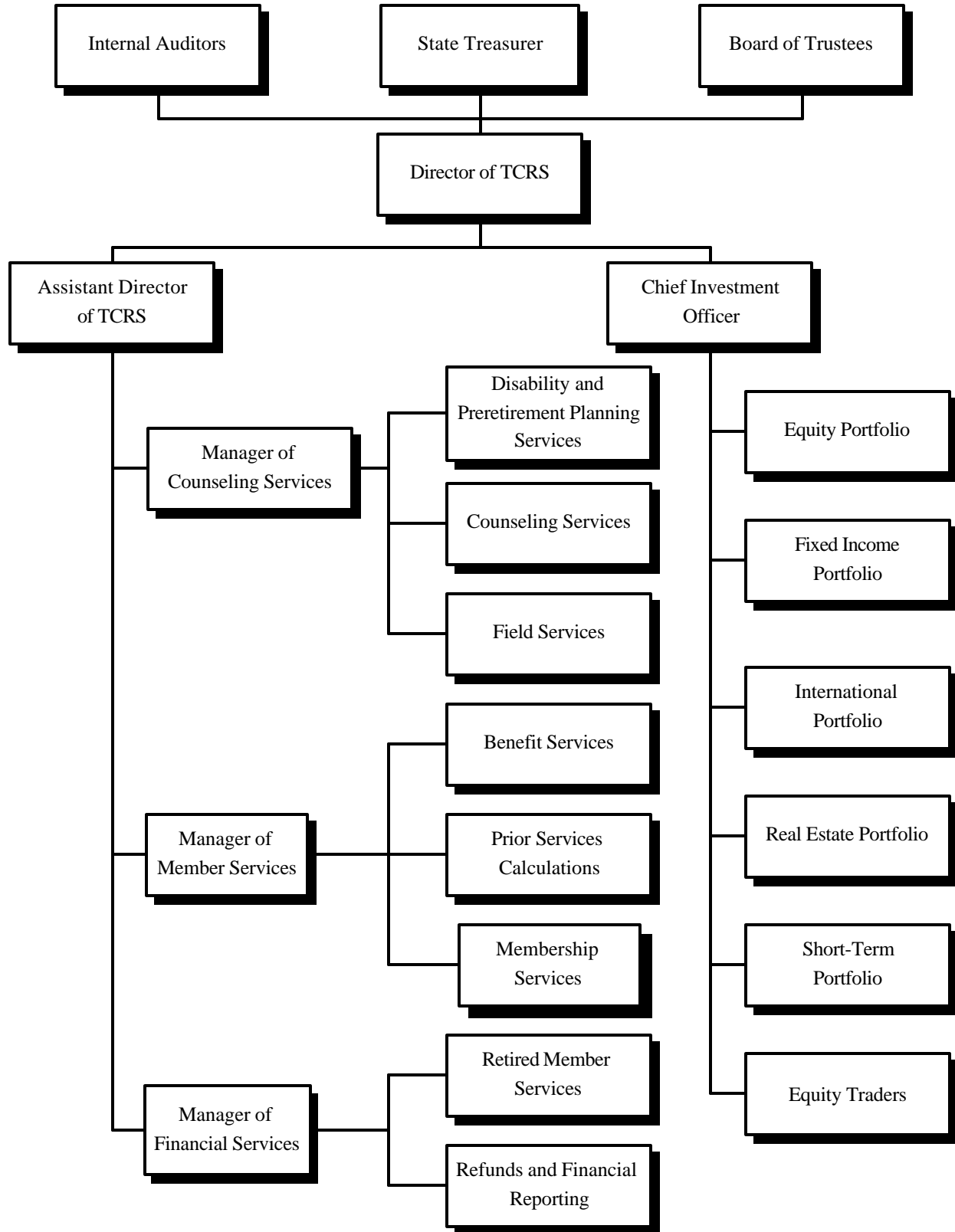
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## **AUDIT SCOPE**

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The audit was limited to the period July 1, 2000, through June 30, 2001, and was conducted in accordance with government auditing standards generally accepted in the United States of America. Financial statements are presented for the year ended June 30, 2001, and for comparative purposes, the year ended June 30, 2000. The Tennessee Consolidated Retirement System forms an integral part of state government and as such has been included as pension trust funds in the *Tennessee Comprehensive Annual Financial Report*.

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM  
ORGANIZATION CHART**



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## OBJECTIVES OF THE AUDIT

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The objectives of the audit were

1. to consider the Tennessee Consolidated Retirement System's internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements;
2. to determine compliance with certain provisions of laws, regulations, and contracts;
3. to determine the fairness of the presentation of the financial statements; and
4. to recommend appropriate actions to correct any deficiencies.

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## PRIOR AUDIT FINDINGS

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There were no findings in the prior audit report.

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## RESULTS OF THE AUDIT

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### AUDIT CONCLUSIONS

#### Internal Control

As part of the audit of the Tennessee Consolidated Retirement System's financial statements for the year ended June 30, 2001, we considered internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements, as required by government auditing standards generally accepted in the United States of America. Reportable conditions, along with recommendations and management's responses, are detailed in the findings and recommendations. Consideration of internal control over financial reporting disclosed no material weaknesses.

#### Compliance

The results of our audit tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Fairness of Financial Statement Presentation

The Division of State Audit has rendered an unqualified opinion on the Tennessee Consolidated Retirement System's financial statements.



**STATE OF TENNESSEE  
COMPTROLLER OF THE TREASURY  
DEPARTMENT OF AUDIT  
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**Report on Compliance and on Internal Control  
Over Financial Reporting Based on an Audit of  
Financial Statements Performed in Accordance With  
*Government Auditing Standards***

December 4, 2001

The Honorable John G. Morgan  
Comptroller of the Treasury  
State Capitol  
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the financial statements of the Tennessee Consolidated Retirement System as of and for the year ended June 30, 2001, and have issued our report thereon dated December 4, 2001. As discussed in Note A.6. to the financial statements of the Tennessee Consolidated Retirement System, the State of Tennessee changed its definition of cash and cash equivalents. We conducted our audit in accordance with government auditing standards generally accepted in the United States of America.

Compliance

As part of obtaining reasonable assurance about whether the system's financial statements are free of material misstatement, we performed tests of the system's compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the system's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial

The Honorable John G. Morgan  
December 4, 2001  
Page Two

reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the system's ability to record, process, summarize, and report financial data consistent with management's assertions in the financial statements.

The following reportable conditions were noted:

- The Tennessee Consolidated Retirement System should develop and implement written procedures related to the preparation and use of credit analysis reports that support the purchase of commercial paper
- TCRS should strengthen controls for preventing, detecting, and collecting overpayments to deceased persons

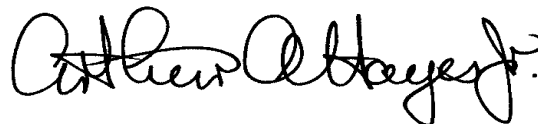
These conditions are described in the Findings and Recommendations section of this report.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control over financial reporting, which we have reported to the system's management in a separate letter.

This report is intended solely for the information and use of the General Assembly of the State of Tennessee and management and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record.

Sincerely,

A handwritten signature in black ink, appearing to read "Arthur A. Hayes, Jr.", with a stylized, cursive script.

Arthur A. Hayes, Jr., CPA,  
Director

AAH/th

## **FINDINGS AND RECOMMENDATIONS**

### **1. The Tennessee Consolidated Retirement System should develop and implement written procedures related to the preparation and use of credit analysis reports that support the purchase of commercial paper**

#### **Finding**

The Board of Trustees establishes investment policies of the Tennessee Consolidated Retirement System (TCRS). Those policies require investment staff to prepare a credit analysis report on a corporation before the TCRS purchases that corporation's commercial paper. The credit analysis report is to include a company profile, business description, financial profile, rating information, strengths and opportunities, weaknesses and threats, and an outlook and recommendation.

Investment staff began preparing the credit analysis reports shortly before the amendment to the investment policies requiring the preparation of these reports was approved in March of 2001. However, guidance on certain aspects of preparing and using the reports is lacking. One directive needed is how often credit analysis reports should be updated. Reports for some corporations have not been updated to reflect the most recent financial information. The latest financial information on these corporations was from December 1999. As of December 4, 2001, these reports had not been updated for 2000, although the investment staff was still making frequent acquisitions of these corporations' commercial paper.

Other guidance needed is how the decision to purchase commercial paper contrary to the recommendation in the credit analysis report should be documented. One instance was noted where a credit analysis report recommended against purchasing commercial paper of a corporation. However, investment staff frequently acquired commercial paper of this corporation contrary to that recommendation without documenting why such a decision was made.

If the period of time for which credit analysis reports are to be valid, when they are to be updated, and how decisions not to follow their recommendations are to be documented are not clearly established, the risk of purchasing commercial paper of a vulnerable corporation is increased.

#### **Recommendation**

The Treasurer should ensure that written procedures for the preparation and use of credit analysis reports that support the purchase of commercial paper are developed. The procedures should indicate the period for which the reports should be valid, when they should be updated, and how decisions not to follow their recommendations should be documented.

## **Management's Comment**

Management concurs. Procedures have been written relative to the process for the preparation and use of credit analysis reports. Regarding the credit analysis report referred to in this finding where the analyst requested a second opinion prior to approval, the chief investment officer of TCRS reviewed and discussed the credit analysis report with the manager of cash management. The chief investment officer, who has final authority for investment decisions, authorized the acquisition of such commercial paper. While we concur that such decisions need to be documented, we would emphasize that the purchase of this commercial paper was properly authorized and the State was not placed at risk by purchasing commercial paper issued by the company in question.

### **2. TCRS should strengthen controls for preventing, detecting, and collecting overpayments to deceased persons**

#### **Finding**

The Tennessee Consolidated Retirement System (TCRS), established in 1972, provides retirement coverage to state employees, higher education employees, teachers, and employees of political subdivisions that have elected to participate in the plan. As of June 30, 2001, there were 194,725 active TCRS members. TCRS paid out \$756.4 million in benefits to retirees and beneficiaries during the year ended June 30, 2001.

#### **Death Match Procedures**

Management receives death match reports from a contracted vendor. The death match reports received from the vendor report matches between the vendor's database of deceased persons and an electronic file submitted by TCRS to the vendor. The electronic file submitted by TCRS to the vendor includes data fields for certain inactive TCRS members and all retirees and beneficiaries. The vendor report includes matches between its database and the electronic file submitted to the vendor by TCRS in three categories: exact matches (last name, first name, social security number, and date of birth), highly probable matches (last name, first name, and either the social security number or the date of birth), and other matches. Management uses these death match reports to identify possible overpayments to deceased retirees and beneficiaries. The death match report received from the vendor, dated April 19, 2001, reported 179 exact matches and 23 highly probable matches. According to information provided by the vendor, there is approximately a 4 percent chance that both exact and highly probable matches are false.

TCRS has written procedures to be performed as a result of information obtained from death match reports. Our review of the procedures performed and discussions with Retired Payroll staff indicated several instances of noncompliance with the written procedures.



- Letters were not sent to every person in the death match report. According to Retired Payroll staff, letters were only sent to retirees and beneficiaries who were reported as exact matches.
- Retiree and beneficiary accounts were not placed in pending status in accordance with time frames established in the written procedures.
- Second letters were not sent.
- Semi-annual death match reports were not obtained from the contracted vendor. Management only requested one death match report from the vendor during fiscal year 2001.
- Periodic status reports were not provided to the Director of TCRS. Written procedures require that staff provide information to the Director of TCRS indicating the number of matches, action taken, and the results of such matches.

In addition to the instances of noncompliance noted above, our review of written procedures and discussions with Retired Payroll personnel indicated internal control weaknesses related to the death match process. Specifically, established procedures used to verify the accuracy of information reported in the death match report are not sufficient to reduce the risk that deceased retirees and beneficiaries are still receiving benefits. In addition, there is no system in place to adequately document the actions taken regarding individuals included in death match reports. These internal control weaknesses are discussed below.

Written procedures require that all individuals reported as deceased in the death match report be sent letters, in part, to verify the status reported in the death match report. For those individuals receiving benefits, the letters are addressed to the beneficiary or the estate of the retiree. If the retiree or beneficiary is not deceased, the letter requires the retiree or beneficiary to indicate this in the letter by checking “no,” signing the letter, and returning the letter to TCRS. If such a letter is returned to TCRS, it is presumed that the retiree or beneficiary is not deceased. As such, a retiree or beneficiary would continue to receive retirement benefits. However, it appears that this control does not sufficiently reduce the risk that the letter was signed fraudulently by someone other than the retiree or beneficiary.

Management has not established a system to adequately and efficiently document and track the status of all persons reported in death match reports. Based on discussions with Retired Payroll personnel, information received in the death match reports is entered manually into an electronic spreadsheet. During the course of the audit, it was noted that the spreadsheet was incomplete and did not contain sufficient information to document the number and type of matches, the actions taken, and the results of the matches. Based on review of the contract with the vendor, the death match reports are available to TCRS in an electronic format. An electronic death match report would provide a more efficient means of accumulating and documenting the information received in the death match reports. In addition, TCRS could modify the vendor’s

electronic file to include additional fields to serve as a tracking mechanism for actions taken and the documentation used for such actions.

Failure to comply with and strengthen procedures related to death match reports increases the risk that payments will continue to be made in the name of deceased retirees and beneficiaries.

### **Accounts Receivable Procedures**

TCRS has written procedures for the collection of overpayments to deceased retirees or beneficiaries. These procedures require an initial letter to be sent advising the payee of the overpayment. If a response to the initial letter is not received within 30 days, procedures require a second letter to be sent under the signature of the Payroll Supervisor. The procedures require the second letter to contain specific information such as reasonable repayment plans. Finally, if a response to the second letter is not received within 30 days, procedures require a third letter to be sent under the signature of a staff attorney. Our testwork on overpayments indicated that neither the Retired Payroll staff nor the staff attorney complied with these written procedures. In addition, our review of overpayment documentation and the related procedures indicated that the procedures did not always provide sufficient guidance for staff performing the procedures and did not address a specific circumstance which routinely occurred as a result of overpayments.

Our testwork regarding the first letter indicated several weaknesses. For 1 of 11 applicable overpayments tested (9%), the required first letter was not sent. In this particular circumstance, a bank sent a cashier's check to TCRS for the overpayment. However, this overpayment was not recorded as an account receivable until 93 days after TCRS was notified of the individual's death. There was no evidence that either the bank or the payee was contacted by letter regarding the overpayment. According to the Payroll Counselor, the bank may have been contacted by phone.

Although the written procedures do not address when the first letters are supposed to be sent, our testwork indicated that the first letters were not always sent in a timely manner. The Payroll Counselor documents the dates on which TCRS was notified of retiree and beneficiary deaths. Using the dates documented by the Payroll Counselor, our testwork indicated that 6 of 24 applicable first letters tested (25%) were sent more than 30 days after TCRS was notified of the retiree's or beneficiary's death. The number of days ranged from 34 to 603. Regarding the dates that TCRS was notified of retiree and beneficiary deaths (as documented by the Payroll Counselor), our testwork indicated that Retired Payroll staff had access to death match reports which provided for an earlier date of notification. For 7 of 25 overpayments tested (28%), death match reports were available which provided an earlier date of notification of retiree and beneficiary deaths. The number of days Retired Payroll had access to the death match reports' notification dates, as compared to the date documented by the Payroll Counselor, ranged from 22 to 98.

In certain circumstances, the first letter required by the written procedures was not sent. For example, when the Payroll Counselor was aware that a deceased retiree's or beneficiary's benefits were paid electronically through an automated clearing house (ACH) transfer between

banks, the required first letter was not sent. Instead, an “ACH letter” was sent to the bank. Although it appears proper to handle such overpayments in this manner, written procedures do not address this routine occurrence. Our testwork indicated a weakness concerning the use of ACH letters. In two instances, a second request ACH letter was sent to the banks. However, the second ACH letter requests were not sent until 584 and 593 days after the first ACH letter was sent.

According to the Payroll Counselor, a receivable for overpayments to deceased retirees and beneficiaries is not recorded in the accounting records until an overpayment worksheet, prepared by the Payroll Counselor, is forwarded to the Accounting Division. Our review of the overpayment worksheets indicated that they were not reviewed or approved by the Payroll Counselor’s supervisor before being forwarded to the Accounting Division. Also, based on discussions with Retired Payroll personnel, neither the second letters (under the signature of the Payroll Supervisor) nor the third letters (under the signature of a staff attorney) were sent to the beneficiaries included in our sample. As of December 4, 2001, 12 of 25 overpayments tested (48%) were still uncollected. Finally, 6 of 25 overpayments tested (24%) were recorded as accounts receivable in the accounting records more than 60 days past the date of the notification of death. The number of days ranged from 93 to 619.

If written procedures over accounts receivable do not adequately address circumstances which arise as a result of overpayments and are not complied with, the risk that accounts receivable will not be collected is increased.

### **Recommendation**

Management should ensure that Retired Payroll staff comply with written procedures for death match reports and that appropriate retiree and beneficiary accounts are placed in pending status promptly. Written procedures should be strengthened to attain a higher level of assurance that information received in the letters returned by retirees and beneficiaries is accurate and sufficient to continue making payments to retirees and beneficiaries who have been reported deceased by the contracted vendor. For example, management should consider requiring these letters to be signed in the presence of a notary public. Finally, to provide for an easier and more efficient means of tracking the follow-up results, management should consider requesting electronic copies of death match reports from the vendor.

The Director of TCRS should ensure that written procedures address the various circumstances that arise as a result of overpayments and that employees comply with the procedures. The Director should ensure that time requirements for sending the first letter to the payee, procedures to perform when a retiree or beneficiary was paid by an automated clearing house transfer, and any reviews and approvals of overpayment documentation are adequately addressed in the written procedures. The written procedures should be designed to ensure that accounts receivable as a result of overpayments are recorded in the accounting records and collected in a reasonable period of time.

### **Management's Comment**

Management concurs. New procedures are being written on the death match process including related overpayment collection. In addition, staff will be properly trained to follow the procedures. At the time this problem was brought to the attention of management, a full review of recent death match reports was performed. Staff has finished that review and taken appropriate action. The problem resulted from the retirement of a long term employee and staff not being properly trained with updated procedures to handle the death match process.



**STATE OF TENNESSEE  
COMPTROLLER OF THE TREASURY  
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**Independent Auditor's Report**

December 4, 2001

The Honorable John G. Morgan  
Comptroller of the Treasury  
State Capitol  
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the accompanying statements of plan net assets of the Tennessee Consolidated Retirement System as of June 30, 2001, and June 30, 2000, and the related statements of changes in plan net assets for the years then ended. These financial statements are the responsibility of management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with government auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Tennessee Consolidated Retirement System as of June 30, 2001, and June 30, 2000, and the results of its operations for the years then ended in conformity with accounting principles generally accepted in the United States of America.

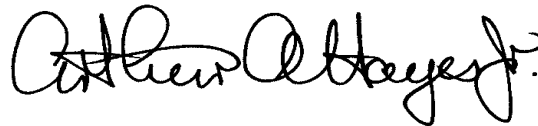
As discussed in Note A.6. to the financial statements, the State of Tennessee changed its definition of cash and cash equivalents.

The Honorable John G. Morgan  
December 4, 2001  
Page Two

The schedules of funding progress and employer contributions on pages 26 and 27 are not required parts of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and do not express an opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 4, 2001, on our consideration of the Tennessee Consolidated Retirement System's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, and contracts. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Sincerely,

A handwritten signature in black ink, reading "Arthur A. Hayes, Jr." in a cursive script.

Arthur A. Hayes, Jr., CPA,  
Director

AAH/th

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM**  
**COMPARATIVE STATEMENTS OF PLAN NET ASSETS**  
**AS OF JUNE 30, 2001 AND JUNE 30, 2000**

*Expressed in Thousands*

	<b>State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)</b>	<b>Political Subdivisions Pension Plan (PSPP)</b>
ASSETS		
Cash and cash equivalents	\$ 676,173	\$ 103,613
Receivables		
Member contributions receivable	15,055	3,809
Employer contributions receivable	17,681	8,447
Accrued interest receivable	160,809	24,641
Accrued dividends receivable	3,840	588
Other investment receivable	101	15
Investments sold	233,929	35,846
Total receivables	431,415	73,346
Investments, at fair value		
Short-term securities	450,688	69,061
Government bonds	7,795,671	1,194,563
Corporate bonds	3,100,092	475,040
Corporate stocks	8,449,363	1,294,730
Real estate	251,798	38,584
Invested securities lending collateral	98,580	15,106
Total investments	20,146,192	3,087,084
TOTAL ASSETS	21,253,780	3,264,043
LIABILITIES		
Accounts payable		
Death benefits and refunds payable	644	359
Other	11	0
Investments purchased	574,728	88,068
Other investment payables	1,840	282
Securities lending collateral	98,580	15,106
TOTAL LIABILITIES	675,803	103,815
NET ASSETS HELD IN TRUST FOR PENSION		
BENEFITS (Schedules of funding progress for the plans are presented on page 32)	\$ 20,577,977	\$ 3,160,228

*See accompanying Notes to the Financial Statements*

*(continued)*

June 30, 2001 Total	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEP)	Political Subdivisions Pension Plan (PSPP)	June 30, 2000 Total
<u>\$ 779,786</u>	<u>\$ 539,755</u>	<u>\$ 80,680</u>	<u>\$ 620,435</u>
18,864	13,565	3,361	16,926
26,128	19,970	6,346	26,316
185,450	164,199	24,632	188,831
4,428	8,710	1,307	10,017
116	0	0	0
269,775	16,453	2,468	18,921
<u>504,761</u>	<u>222,897</u>	<u>38,114</u>	<u>261,011</u>
519,749	294,164	44,129	338,293
8,990,234	8,213,549	1,232,168	9,445,717
3,575,132	3,119,945	468,044	3,587,989
9,744,093	8,682,844	1,302,570	9,985,414
290,382	133,285	19,995	153,280
113,686	0	0	0
<u>23,233,276</u>	<u>20,443,787</u>	<u>3,066,906</u>	<u>23,510,693</u>
<u>24,517,823</u>	<u>21,206,439</u>	<u>3,185,700</u>	<u>24,392,139</u>
1,003	1,385	583	1,968
11	13	1	14
662,796	41,966	6,296	48,262
2,122	3,666	550	4,216
113,686	0	0	0
<u>779,618</u>	<u>47,030</u>	<u>7,430</u>	<u>54,460</u>
<u>\$ 23,738,205</u>	<u>\$ 21,159,409</u>	<u>\$ 3,178,270</u>	<u>\$ 24,337,679</u>



**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM**  
**COMPARATIVE STATEMENTS OF CHANGES IN PLAN NET ASSETS**  
**FOR THE YEARS ENDED JUNE 30, 2001 AND JUNE 30, 2000**

*Expressed in Thousands*

	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEEPP)	Political Subdivisions Pension Plan (PSPP)
ADDITIONS		
Contributions		
Member contributions	\$ 135,154	\$ 45,433
Employer contributions	232,149	103,681
Total contributions	<u>367,303</u>	<u>149,114</u>
Investment income		
Net appreciation (depreciation) in fair value of investments	(1,198,688)	(184,059)
Interest	806,941	123,906
Dividends	101,496	15,585
Real estate income, net of operating expenses	16,525	2,538
Total investment income (loss)	<u>(273,726)</u>	<u>(42,030)</u>
Less: Investment expense	<u>10,738</u>	<u>1,637</u>
Net income (loss) from investing activities	<u>(284,464)</u>	<u>(43,667)</u>
Securities lending activities		
Securities lending income	2,078	319
Less: securities lending expense	<u>1,540</u>	<u>237</u>
Net income from securities lending activities	<u>538</u>	<u>82</u>
Net investment income (loss)	<u>(283,926)</u>	<u>(43,585)</u>
Transfer of assets from PSPP	12,604	0
TOTAL ADDITIONS	<u>95,981</u>	<u>105,529</u>
DEDUCTIONS		
Annuity benefits		
Retirement benefits	491,204	75,517
Survivor benefits	31,224	4,800
Disability benefits	16,094	2,474
Cost of living	116,892	13,477
Death benefits	3,720	982
Refunds	16,484	12,034
Administrative expense	1,795	1,683
Transfer of assets to SETHEEPP	<u>0</u>	<u>12,604</u>
TOTAL DEDUCTIONS	<u>677,413</u>	<u>123,571</u>
NET INCREASE (DECREASE)	<u>(581,432)</u>	<u>(18,042)</u>
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS		
BEGINNING OF YEAR	21,159,409	3,178,270
END OF YEAR	<u>\$ 20,577,977</u>	<u>\$ 3,160,228</u>

*See accompanying Notes to the Financial Statements*

*(continued)*

June 30, 2001 Total	State Employees, Teachers, Higher Education Employees Pension Plan (SETHEPP)	Political Subdivisions Pension Plan (PSPP)	June 30, 2000 Total
\$ 180,587	\$ 129,925	\$ 39,906	\$ 169,831
335,830	252,162	82,749	334,911
<u>516,417</u>	<u>382,087</u>	<u>122,655</u>	<u>504,742</u>
(1,382,747)	663,408	98,645	762,053
930,847	768,033	114,203	882,236
117,081	108,596	16,148	124,744
19,063	3,567	530	4,097
<u>(315,756)</u>	<u>1,543,604</u>	<u>229,526</u>	<u>1,773,130</u>
12,375	10,491	1,565	12,056
<u>(328,131)</u>	<u>1,533,113</u>	<u>227,961</u>	<u>1,761,074</u>
2,397	0	0	0
1,777	0	0	0
620	0	0	0
<u>(327,511)</u>	<u>1,533,113</u>	<u>227,961</u>	<u>1,761,074</u>
12,604	0	0	0
<u>201,510</u>	<u>1,915,200</u>	<u>350,616</u>	<u>2,265,816</u>
566,721	450,919	69,164	520,083
36,024	28,839	4,423	33,262
18,568	15,089	2,315	17,404
130,369	106,542	11,933	118,475
4,702	2,658	852	3,510
28,518	15,474	13,088	28,562
3,478	2,363	1,990	4,353
12,604	0	0	0
<u>800,984</u>	<u>621,884</u>	<u>103,765</u>	<u>725,649</u>
(599,474)	1,293,316	246,851	1,540,167
24,337,679	19,866,093	2,931,419	22,797,512
<u>\$ 23,738,205</u>	<u>\$ 21,159,409</u>	<u>\$ 3,178,270</u>	<u>\$ 24,337,679</u>

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# TENNESSEE CONSOLIDATED RETIREMENT SYSTEM

## NOTES TO THE FINANCIAL STATEMENTS

### JUNE 30, 2001 AND JUNE 30, 2000

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The Tennessee Consolidated Retirement System (TCRS) administers two defined benefit pension plans - State Employees, Teachers and Higher Education Employees Pension Plan (SETHEEPP) and Political Subdivisions Pension Plan (PSPP). Although the assets of the plans are commingled for investment purposes, each plan's assets may be used only for the payment of benefits to members of that plan, in accordance with the terms of the plan.

#### **A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

##### **1. Reporting Entity**

The TCRS is included in the State of Tennessee Financial Reporting Entity. Because of the state's fiduciary responsibility, the TCRS has been included as pension trust funds in the *Tennessee Comprehensive Annual Financial Report*.

##### **2. Measurement Focus and Basis of Accounting**

The accompanying financial statements have been prepared in conformity with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board (GASB). The TCRS follows all applicable GASB pronouncements, as well as applicable private sector pronouncements issued on or before November 30, 1989. The financial statements have been prepared using the flow of economic resources measurement focus and the accrual basis of accounting. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

Plan member contributions are recognized in the period in which the contributions are due. Plan employer contributions are recognized when due and the employer has made a formal commitment to provide the contributions. Benefits and refunds are recognized when due and payable in accordance with the terms of each plan.

##### **3. Cash and Cash Equivalents**

Cash and cash equivalents, by definition, includes cash and short-term investments with a maturity date within three months of the acquisition date. The state's accounting policy regarding the definition of cash and cash equivalents includes cash management pools as cash. Cash received by the TCRS that cannot be invested immediately in securities is invested in the State Pooled Investment Fund administered by the State Treasurer. The State Pooled Investment Fund is authorized by state statute to invest funds in accordance with policy guidelines approved by the Funding Board of the State of Tennessee. The current resolution of that board gives the Treasurer authority to invest in collateralized certificates of deposit in authorized state depositories, prime commercial paper, prime bankers' acceptances, certain repurchase agreements, various U.S. Treasury and Agency obligations, and in obligations of the State of Tennessee pursuant to *Tennessee Code Annotated*, Section 9-4-602(b). The State Pooled Investment Fund is also authorized to enter into securities lending agreements in which U.S. Government Securities may be loaned for a fee. The loaned securities are transferred to the borrower by the custodial agent upon simultaneous receipt of collateral securities. The pool's custodial credit risk is presented in the *Tennessee Comprehensive Annual Financial Report* for the years ended June 30, 2001 and June 30, 2000. The classification of cash and cash equivalents also includes cash held in a custody account under a contractual arrangement for master custody services. Cash balances with the custodial agent are not classified into the credit risk categories established by Statement Number 3 of the Governmental Accounting Standards Board as the custody account relationship does not meet the definition for either a deposit with a financial institution or a security.

##### **4. Method Used to Value Investments**

Investments are reported at fair value. Securities traded on a national or international exchange are valued at the last reported sales price at current exchange rates. Short-term investments that do not have an established market are reported at cost plus accrued interest which approximates fair value. The fair value of real estate investments is determined at least every three years by qualified independent appraisers who are members of the Appraisal Institute and internally by real estate advisors for those years when independent appraisals are not performed. Investment income consists of realized and unrealized appreciation (depreciation) in the fair value of investments. Interest income is recognized when earned. Securities and securities transactions are recorded in the financial statements on trade-date basis.

##### **5. Receivables**

Receivables primarily consist of interest which is recorded when earned. The receivables for contributions as of June 30, 2001 consist of member contributions of \$15.1 million and \$3.8 million due to SETHEEPP and PSPP respectively, and employer contributions of \$17.7 million and \$8.4 million due to SETHEEPP and PSPP respectively. The receivables for contributions as of June 30, 2000 consist of member contributions of \$13.6 million and \$3.3 million due to SETHEEPP and PSPP respectively, and employer contributions of \$20.0 million and \$6.3 million due to SETHEEPP and PSPP respectively.

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**JUNE 30, 2001 AND JUNE 30, 2000 (CONTINUED)**

**6. Accounting Change**

During Fiscal Year 2001, the state changed its definition of cash and cash equivalents for certain short-term securities which were previously classified as investments regardless of the period from acquisition to maturity. These securities are now included in cash and cash equivalents on the Statement of Plan Net Assets if the maturity date is within three months of the acquisition date. Due to this change, short-term investments of \$619.2 million as previously reported on the June 30, 2000 Statement of Plan Net Assets have been included in cash and cash equivalents for comparative purposes.

**7. Reclassifications**

Certain amounts previously presented in the June 30, 2000 financial statements have been reclassified for comparative purposes. Investment expenses of \$3.1 million have been reclassified to net appreciation in fair value of investments. In addition, \$14.1 million previously reported as retired payroll (checks) payable and \$931,000 previously reported for warrants payable have been reclassified as reductions to cash and cash equivalents. The issuance of warrants and checks, rather than their redemption through the banking system is deemed to effectively reduce cash.

**B. PLAN DESCRIPTIONS AND CONTRIBUTION INFORMATION**

At July 1, 1999, the date of the latest actuarial valuation, the membership of each plan consisted of the following:

	SETHEEPP	PSPP
Retirees and beneficiaries currently receiving benefits	52,177	19,469
Terminated members entitled to but not receiving benefits	12,948	2,635
Current active members	<u>123,540</u>	<u>64,540</u>
Total	188,665	86,644
Number of participating employers	140	394

**State Employees, Teachers and Higher Education Employees Pension Plan**

*Plan Description*

SETHEEPP is a cost-sharing, multiple employer defined benefit pension plan that covers the employees of the state, teachers with Local Education Agencies (LEA's) and higher education employees. The TCRS provides retirement benefits as well as death and disability benefits to plan members and their beneficiaries. Benefits are determined by a formula using the member's high five-year average salary and years of service. Members become eligible to retire at the age of 60 with five years of service or at any age with 30 years of service. A reduced retirement benefit is available to vested members who are at least 55 years of age or have 25 years of service. Disability benefits are available to active members with five years of service who become disabled and cannot engage in gainful employment. There is no service requirement for disability that is the result of an accident or injury occurring while the member was in the performance of duty. Members joining the plan on or after July 1, 1979 are vested after five years of service. Members joining prior to July 1, 1979 are vested after four years of service. Compounded cost of living adjustments (COLA) are provided each July based on the percentage change in the Consumer Price Index (CPI) during the previous calendar year except that (a) no COLA is granted if the CPI is less than one-half percent; (b) a COLA of 1% will be granted if the CPI increases between one-half percent and one percent; (c) the maximum annual COLA is capped at three percent. Benefit provisions are established by state statute found in Title Eight, Chapters 34 through 37 of the *Tennessee Code Annotated*. State statutes are amended by the Tennessee General Assembly. Ad hoc increases may only be authorized by the General Assembly. Public safety officers receive an additional supplemental benefit that is paid from age 60 to age 62.

*Superseded Systems and Certain Employment Classifications*

Members of superseded systems that became members of the TCRS at consolidation in 1972, have their rights preserved to the benefits of the superseded system, if the benefit from the superseded plan exceeds that provided by the Group 1 (teachers and general employees) TCRS formula. Likewise, public safety employees and officials of TCRS Groups 2, 3 and 4 are entitled to the benefits of those formulas, if better than the Group 1 benefits.

*Contributions and Reserves*

Effective July 1, 1981, the plan became noncontributory for most state and higher education employees. The contribution rate for teachers is five percent of gross salary. The employers contribute a set percentage of their payrolls, determined by an actuarial valuation. *Tennessee Code Annotated* Title Eight, Chapter 37 provides that the contribution rates be established and may be amended by the Board of Trustees of the TCRS. The administrative budget for the plan is approved through the State of Tennessee's annual budget process. Funding for the administrative budget is included in employer contributions.

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# TENNESSEE CONSOLIDATED RETIREMENT SYSTEM

## NOTES TO THE FINANCIAL STATEMENTS

### JUNE 30, 2001 AND JUNE 30, 2000 (CONTINUED)

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The net assets of the plan are legally required to be reserved in two accounts, the Member Reserve and the Employer Reserve. The Member Reserve represents the accumulation of employee contributions plus interest. The Employer Reserve represents the accumulation of employer contributions, investment income and transfers from the Member Reserve for retiring members. Benefit payments and interest credited to the members' accounts are reductions to the Employer Reserve. At June 30, 2001, the plan's Member Reserve and Employer Reserve were fully funded with balances of \$2,640.7 million and \$17,937.3 million, respectively. At June 30, 2000, the plan's Member Reserve and Employer Reserve were fully funded with balances of \$2,521.5 million and \$18,637.9 million, respectively.

#### **Political Subdivisions Pension Plan**

##### *Plan Description*

PSPP is an agent multiple-employer defined benefit pension plan that covers the employees of participating political subdivisions of the State of Tennessee. Employee class differentiations are not made under PSPP. The TCRS provides retirement benefits as well as death and disability benefits to plan members and their beneficiaries. Benefits are determined by a formula using the member's high five-year average salary and years of service. Members become eligible to retire at the age of 60 with five years of service or at any age with 30 years of service. A reduced retirement benefit is available to vested members who are at least 55 years of age or have 25 years of service. Disability benefits are available to active members with five years of service who become disabled and cannot engage in gainful employment. There is no service requirement for disability that is the result of an accident or injury occurring while the member was in the performance of duty. Members joining the plan prior to July 1, 1979 are vested after four years of service. Members joining on or after July 1, 1979 are vested upon completion of 10 years of service, unless five years vesting is authorized by resolution of the chief governing body. Cost of living adjustments (COLA) are the same as provided by SETHEEPP except that the local government may elect (a) to provide no COLA benefits or (b) to provide COLA benefits under a non-compounding basis rather than the compounded basis applicable under SETHEEPP. Benefit provisions are established and amended by state statute. Pursuant to Article Two, Section 24 of the *Constitution of the State of Tennessee*, the state cannot mandate costs on local governments. Any benefit improvement may be adopted by the governing body of a governmental entity participating in the TCRS.

*Contributions and Reserves* - Political subdivisions may elect contributory or noncontributory retirement for their employees. The contribution rate for contributory employees of political subdivisions is five percent of gross salary. The employers contribute a set percentage of their payrolls, equal to at least, the percentage determined by an actuarial valuation. State statute provides that the contribution rates be established and may be amended by the Board of Trustees of the TCRS. The administrative budget for the plan is approved through the state's annual budget process. Funding for the administrative budget is included in employer contributions.

The net assets of the plan are legally required to be reserved in two accounts, the Member Reserve and the Employer Reserve. The Member Reserve represents the accumulation of employee contributions plus interest. The Employer Reserve represents the accumulation of employer contributions, investment income and transfers from the Member Reserve for retiring members. Benefit payments and interest credited to the members' accounts are reductions to the Employer Reserve. At June 30, 2001, the plan's Member Reserve and Employer Reserve were fully funded with balances of \$592.3 million and \$2,567.9 million, respectively. At June 30, 2000, the plan's Member Reserve and Employer Reserve were fully funded with balances of \$541.8 million and \$2,636.5 million, respectively.

#### **C. PLAN TRANSFERS**

During Fiscal Year 2001, assets in the amount of \$12.6 million relating to the Regional Library System were transferred from the PSPP to the SETHEEPP. Under *Tennessee Code Annotated*, Section 10, Chapter 5, Part 2, the employees of the Regional Library System, whose retirement assets were included in the PSPP, became employees of the Department of State, which is under the SETHEEPP plan.

#### **D. INVESTMENTS**

State statute authorizes the TCRS to invest in bonds, debentures, preferred stock and common stock, real estate and in other good and solvent securities subject to the approval of the Board of Trustees and further subject to the following restrictions:

- a. The total sum invested in common and preferred stocks shall not exceed seventy-five percent (75%) of the total of the funds of the retirement system.
- b. The total sum invested in notes and bonds or other fixed income securities exceeding one year in maturity shall not exceed seventy-five percent (75%) of the total funds of the retirement system. Private Placements are limited to 15% of the total fixed income portfolio.

(continued)

**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**JUNE 30, 2001 AND JUNE 30, 2000 (CONTINUED)**

- c. Within the restrictions in (a) and (b) above, an amount not to exceed fifteen percent (15%) of the total of the funds of the retirement system may be invested in securities of the same kinds, classes, and investment grades as those otherwise eligible for investment in various approved foreign countries.
- d. The total amount of securities loaned under a securities lending program cannot exceed thirty percent (30%) of total assets.
- e. The total sum invested in real estate shall not exceed five percent (5%) of the total of the funds of the retirement system.

The TCRS investment securities are categorized on the chart that follows according to the level of custodial credit risk associated with the custodial arrangements. Category 1 includes investments that are insured or registered, or for which the securities are held by the TCRS or its agent in the name of the TCRS. Category 2 includes uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent in the name of the TCRS. Category 3 includes uninsured and unregistered investments for which the securities are held by the broker or dealer, or by the counterparty's trust department or agent, but not in the name of the TCRS.

<i>Expressed in Thousands</i>	<b>Fair Value June 30, 2001</b>	<b>Fair Value June 30, 2000</b>
Investments - Category 1		
Cash equivalents and short-term securities		
Commercial paper	\$ 751,889	\$ 464,308
Corporate notes	15,320	58,102
Government bonds	533,584	435,128
Long-term investments		
Government bonds	8,872,472	9,434,325
Corporate bonds	3,575,132	3,567,843
Corporate stocks	9,102,052	9,956,951
Total investments - Category 1	<u>22,850,449</u>	<u>23,916,657</u>
Investments - Category 2	<u>0</u>	<u>0</u>
Investments - Category 3		
Short-term securities lending collateral		
investments held by custodian bank	113,686	0
Margin deposit on futures contracts		
Government bonds	0	11,392
Total investments - Category 3	<u>113,686</u>	<u>11,392</u>
Investments - Not Categorized		
Investments held by broker-dealers under		
securities on loan contracts for cash collateral		
Corporate stocks	97,563	0
Real estate	290,382	153,280
Unsettled investment acquisitions		
Government bonds	117,762	0
Corporate bonds	0	20,146
Corporate stocks	544,478	28,463
Total investments - Not Categorized	<u>1,050,185</u>	<u>201,889</u>
Total investments and invested securities lending collateral	<u>24,014,320</u>	<u>24,129,938</u>
Less: Short-term securities included in cash equivalents		
on the Statements of Plan Net Assets	<u>(781,044)</u>	<u>(619,245)</u>
Total investments as shown on the Statements		
of Plan Net Assets	<u>\$ 23,233,276</u>	<u>\$ 23,510,693</u>

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**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**JUNE 30, 2001 AND JUNE 30, 2000 (CONTINUED)**

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As of June 30, 2001 and June 30, 2000, the TCRS had no concentrations of investments, other than those issued or guaranteed by the U.S. government, in any one organization that represents five percent or more of plan net assets.

*Securities Lending*

The TCRS is authorized by its investment policy, as adopted by the Board of Trustees, to enter into collateralized securities lending agreements whereby the TCRS loans its debt and equity securities for a fee to a select few of the highest quality securities firms and banks. Loans must be limited so the total amount on loan does not exceed 30 percent of the TCRS' assets. The TCRS' custodian bank manages the lending program and maintains the collateral on behalf of the TCRS. Under the securities lending agreement, only cash may be accepted as collateral for securities on loan. Cash received as collateral may be reinvested by the lending agent in accordance with the investment policy, as further restricted under the TCRS securities lending agreement. Collateral securities cannot be pledged or sold unless the borrower defaults.

The loaned securities are initially collateralized at 102 percent of their fair value for domestic securities and 105 percent for international. Collateral is marked-to-market daily and additional collateral is pledged by the borrower if the fair value of the collateral subsequently falls below 100 percent for domestic securities and 105 percent for international. Although there is no specific policy for matching the maturities of collateral investments and the securities loans, the total average maturity on the cash collateral investment portfolio cannot exceed fifteen days under the securities lending agreement and the securities on loan can be terminated on demand by either the TCRS or the borrower. At June 30, 2001, the weighted average maturity of invested collateral was 8.9 days. In the event of a default by a borrower, the securities lending agreement includes provisions for the securities lending agent to purchase replacement securities from the sales proceeds of collateral, as well as credit the TCRS with the value of all distributions on the loaned securities. If the collateral proceeds are insufficient to cover the amounts due to the TCRS, the lending agent is responsible for crediting the TCRS for the remaining amounts owed by the borrower. As of June 30, 2001, the fair value of securities on loan to brokers was \$97,563,290 and the fair value of collateral pledged for the securities on loan was \$113,685,867. At June 30, 2001, the TCRS had no credit risk exposure to borrowers as the amounts owed to borrowers exceeded the amounts the borrowers owed the TCRS. For the year ended June 30, 2000, the TCRS had no securities on loan.

*Financial Instruments with Off-Balance Sheet Risk*

The TCRS is a party to financial instruments with off-balance sheet risk used in the normal course of business to generate earnings and reduce its own exposure to fluctuations in market conditions. The TCRS is authorized by statute to engage in forward contracts to exchange different currencies at a specified future date and rate and in domestic stock index futures contracts. These contracts involve elements of custodial credit, market and legal risk in excess of amounts recognized in the Statements of Plan Net Assets as of June 30, 2001 and June 30, 2000. The TCRS may purchase or sell domestic stock index futures contracts for the purposes of making asset allocation changes and improving liquidity. Futures contracts are limited to the S&P 500 Index, the S&P Midcap 400 Index and the Russell 2000 Index. The contractual or notional amounts express the extent of the TCRS' involvement in these instruments and do not represent exposure to credit loss. The credit risk on forward and futures contracts is controlled through limits and monitoring procedures. Market risk, the risk that changing market conditions may make a financial instrument less valuable, is controlled through limitations on the use of such instruments. Legal risk is controlled through the use of only authorized instruments and brokers. The allowable currencies for hedging purposes are limited by policy of the Board of Trustees to the currencies of those countries otherwise authorized for investment.

At June 30, 2001, there were forward exchange contracts outstanding at a total net notional amount of \$17,113,000 and a fair value of \$17,392,319. At June 30, 2000, there were forward exchange contracts outstanding at a total net notional amount of \$118,673,979 and a fair value of \$89,933,176.

At June 30, 2001, the TCRS was not under any futures contracts. At June 30, 2000, the notional amount of futures contracts was \$185,518,750 at a fair value of \$183,512,500. The changes in fair value of outstanding futures contracts are settled daily.

The TCRS is also authorized by investment policy to engage in the issuance of options. Activity is limited to selling covered call options. The TCRS had no options outstanding at June 30, 2001 and June 30, 2000.

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**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**JUNE 30, 2001 AND JUNE 30, 2000 (CONTINUED)**

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*Asset-Backed Securities*

The TCRS invests in collateralized mortgage obligations (CMOs) which are mortgage-backed securities. These securities are based on cash flows from interest and principal payments on underlying mortgages. Therefore, they are sensitive to prepayments by mortgagees, which may result from a decline in interest rates. The CMOs held were issued by quasi-U.S. governmental agencies. There were no CMOs held at June 30, 2001. The fair value of CMOs held at June 30, 2000 was \$50,366,466. The TCRS also invests in various asset-backed securities, representing ownership interests in trusts consisting of credit card or auto loan receivables. These securities are issued by organizations with AAA or AA credit ratings. TCRS invests in these securities primarily to enhance returns by taking advantage of opportunities available in this sector of the securities markets.

During Fiscal Year 2001, the TCRS purchased commercial paper issued by Pacific Gas and Electric Company (PG&E) which was due to mature at \$25,994,000. PG&E defaulted on the maturity payment and filed for reorganization under Chapter 11 of the U.S. Bankruptcy Code. As of the date of issuance of the TCRS financial statements, the reorganization plan was still pending. However, it is the TCRS's opinion that any loss of principal resulting from the bankruptcy court's decision is more than remote but less than likely.

**E. COMMITMENTS**

**Standby Commercial Paper Purchase Agreement**

The TCRS has agreed to serve as standby commercial paper purchaser for commercial paper issued by the Funding Board of the State of Tennessee. By serving as a standby commercial paper purchaser, the TCRS receives an annual fee of 7.5 basis points on the \$250 million maximum issuance under this agreement during times when both Moody's and Standard and Poor's investment ratings assigned to the State of Tennessee's general obligation bonds are Aaa and AAA respectively, and 12 basis points during times when either Moody's or Standard and Poor's has assigned ratings other than Aaa and AAA respectively. In the unlikely event that the TCRS would be called upon to purchase the commercial paper, the TCRS would receive interest at a rate equal to prime plus 75 basis points during the first 30 consecutive days, plus an additional 50 basis points for each consecutive 30 days thereafter, up to a maximum rate allowed by state law.



**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM**  
**REQUIRED SUPPLEMENTARY INFORMATION**  
**SCHEDULES OF FUNDING PROGRESS AND EMPLOYER CONTRIBUTIONS**

**SCHEDULES OF FUNDING PROGRESS**

*Expressed in Thousands*

	Actuarial Valuation Date	Actuarial Value of Plan Assets (a)	Actuarial Accrued Liability (AAL) Frozen Entry Age (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Annual Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
<b>SETHEEPP</b>	7/1/99	\$ 18,327,133	\$ 18,420,156	\$ 93,023	99.49%	\$ 4,132,409	2.25%
	6/30/97	15,671,678	15,782,850	111,172	99.30%	3,810,231	2.92%
<b>PSPP</b>	7/1/99	2,690,781	2,890,942	200,161	93.08%	1,341,363	14.92%
	6/30/97	2,226,891	2,287,904	61,013	97.33%	1,130,585	5.40%

The SETHEEPP is comprised of a number of employee groups. However, the unfunded liability of \$93.0 million at July 1, 1999 is attributable to two employee groups: 1) County Officials employed prior to July 1, 1972 and 2) State Judges and Attorneys General employed prior to July 1, 1972. The PSPP represents 394 participating entities at July 1, 1999. The unfunded liability of \$200.1 million is attributable to 258 of the 394 entities.

*See accompanying Notes to Required Supplementary Information*

**SCHEDULES OF EMPLOYER CONTRIBUTIONS**

*Expressed in Thousands*

Year Ended June 30	SETHEEPP		PSPP	
	Annual Required Contribution	Percentage Contributed	Annual Required Contribution	Percentage Contributed
2001	\$ 232,149	100%	\$ 103,681	100%
2000	252,162	100%	82,749	100%
1999	244,453	100%	69,230	100%
1998	166,756	100%		

An actuarial valuation of the TCRS is performed every two years with the next valuation scheduled to be effective July 1, 2001. The June 30, 1995 valuation determined the employer contribution rate for the year ended June 30, 1997 for the SETHEEPP and the PSPP, and for the year ended June 30, 1998 for the PSPP. Therefore, the Schedule of Employer Contributions, in accordance with the parameters of GASB Statement Number 25, is not available for the year ended June 30, 1997 for either plan or for the year ended June 30, 1998 for the PSPP.

*See accompanying Notes to Required Supplementary Information*

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**TENNESSEE CONSOLIDATED RETIREMENT SYSTEM**  
**NOTES TO REQUIRED SUPPLEMENTARY INFORMATION**  
**AS OF JUNE 30, 2001 AND JUNE 30, 2000**

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The information presented in the required supplementary schedules was determined as part of the actuarial valuations at the dates indicated. Additional information as of the July 1, 1999 actuarial valuation follows.

	<u>SETHEEPP</u>	<u>PSPP</u>
Valuation Date	July 1, 1999	July 1, 1999
Actuarial cost method	Frozen Entry Age	Frozen Entry Age
Amortization method	Level Dollar	Level Dollar
Remaining amortization period	16 years closed period	(1) closed period
Asset valuation method	5-year Moving Market Average	5-year Moving Market Average
Actuarial assumptions:		
Investment rate of return	7.5%	7.5%
Projected salary increases	5.5%	5.5%
Includes inflation at	(2)	(2)
Cost-of-living adjustments	3%	3%
Increase in Social Security wage base	4.5%	4.5%

- (1) The length of the amortization period varies by political subdivision. For political subdivisions entering the plan on or after July 1, 1994, the amortization period does not exceed 20 years.
- (2) No explicit assumption is made regarding the portion attributable to the effect of inflation on salaries.